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EX PARTE

ORIGINAL

Mr. William F. Caton
Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended; and Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area, CC Docket No. 96-149

Dear Mr. Caton:

On September 30, 1996, Donald J. Elardo, Kim Kirby, Anthony C. Epstein and I, representing MCI Telecommunications Corporation (MCI), met with Linda Kinney, Radhika V. Karmarkar, Cheryl A. Leanza, Michelle M. Carey and Sarah E. Whitesell of the Policy and Program Planning Division to discuss MCI's position in the above-captioned proceeding. During that meeting, the Commission staff attendees requested MCI to provide further written responses on several points raised in the discussion. Attached are MCI's Responses to those inquiries.

Two copies of this letter and attachment are being submitted. Please include a copy in the public record of this proceeding.

Yours truly,

Frank W. Krogh

Frank W. Krogh

cc: Linda Kinney
Radhika V. Karmarkar
Cheryl A. Leanza
Michelle M. Carey
Sarah E. Whitesell

RESPONSES TO COMMISSION STAFF QUESTIONS
RE: CC DOCKET NO. 96-149

1. Do Sections 271 and 272 prohibit a Bell Operating Company (BOC) from providing on a wholesale basis facilities that are used to provide interLATA services, or do they just prohibit a BOC from providing interLATA services on a retail or wholesale basis? In other words, can a BOC build an interLATA network and lease it out to its affiliate and others on a nondiscriminatory basis?

The leasing of facilities by a BOC to its interLATA affiliate for the provision of in-region services would be no different in substance from the provision of such services by the BOC, which is prohibited by Section 272(a). The Commission has characterized agreements for interconnection or for the lease of facilities as serving "in lieu of tariffs."[1] In MCI Telecommunications Corp. v. FCC, 842 F.2d 1296 (D.C. Cir. 1988), the Court rejected the Commission's finding that certain facilities leases and tariffed special access services were not "like" services for purposes of Section 202(a), since the Commission had not examined the leases to determine whether, in fact, they were like special access services. Id. at 1305. Moreover, the Commission conceded in that case that facilities leases and tariffed services were not necessarily unlike simply because one involves the leasing of facilities and the other the provision of services. Id.

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[1] Exchange Network Facilities for Interstate Access, 71 FCC 2d 440, 447 n.12 (1979).

Thus, given the Commission's and courts' long-standing views as to the functional similarity of facilities leases and tariffed services, it is clear that the prohibition in Section 272 against BOC unseparated provision of interLATA services must extend to BOC provision of the facilities used to provide such services as well.

This interpretation is consistent with the purposes of Section 272. Permitting BOCs to make arbitrary distinctions between provision of services and provision of facilities would undermine the structural separation principle. In light of their functional similarity, allowing one while prohibiting the other would create tremendous enforcement difficulties, requiring a more intrusive regulatory regime to ensure the separation of the BOC and its interLATA affiliate.

2. A BOC interLATA affiliate can buy BOC local services at generally available wholesale rates for resale. Why can't a BOC interLATA affiliate also buy unbundled elements from the BOC, provided they are generally available to all carriers on nondiscriminatory terms?

Section 272(g)(1) creates a limited exception to the structural separation requirements in Section 272(b) that permits a BOC's interLATA affiliate to market or sell the BOC's local service, provided the BOC permits its affiliate's competitors to market and sell its local services. This exception allows the

interLATA affiliate to resell the BOC's local service (or to act as a sales agent) because a reseller (or sales agent) is basically providing marketing functions.

This exception, however, does not permit the interLATA affiliate to purchase unbundled network elements from the BOC, particularly elements that the affiliate would use to provide its own local exchange or exchange access service. Opportunities for discrimination and cross-subsidy are substantially greater when a BOC provides network elements to its affiliate than when it offers retail services at a standard wholesale discount. For example, under Section 251(c), a carrier can request a BOC to modify its network to make available new network elements, provided it is technically feasible for the BOC to do so. A BOC could favor its affiliate in myriad ways in providing such elements, and these tactics would be extraordinarily difficult, if not impossible, to prevent, detect, or remedy. The result is that the BOC affiliate would get the network elements it wanted, and its competitors would not, and certainly not on a timely basis.

In some circumstances, purchasers of network elements may assume greater risks than those who purchase services for resale.[2] In light of their common ownership, however, the practical allocation of risk between the BOC and its affiliate

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[2] Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, FCC 96-325 (released Aug. 8, 1996)(First R&O), at ¶ 334, pet. for review pending sub nom., Iowa Utilities Board et al. v. FCC, No. 96-3321 and consolidated cases (8th Cir. filed Sept. 6, 1996).

would be different: when the interLATA affiliate obtained network elements from the local affiliate, the parent would effectively assume the risk; but when an unaffiliated carrier obtained network elements, it would assume the risk -- a form of cross-subsidization of the affiliate by the parent as well as a discriminatory advantage. Opportunities for such discrimination and cross-subsidization are less extensive with respect to resale of local services where one affiliate performs only marketing functions for the other.

In addition, unaffiliated carriers are likely to use network elements obtained from the BOCs in combination with their own facilities to provide telecommunications services. Indeed, the BOCs and other incumbent local exchange carriers argued that carriers can obtain access to network elements only if they have their own facilities.[3] The Commission concluded that carriers may obtain BOC network elements even if they do not own their own local exchange facilities,[4] but it recognized that carriers may be able to make better use of network elements if they also have their own facilities.[5] For reasons MCI has explained in its comments in this docket, the structural separation requirements in section 272 do not permit a BOC interLATA affiliate to own facilities and equipment used to provide local exchange and exchange access services. Allowing the interLATA affiliate to

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[3] Id. at ¶¶ 318-22.

[4] Id. at ¶¶ 328-41.

[5] Id. at ¶ 330.

exercise exclusive control over BOC network elements would open the door to widescale evasion and frustration of the Section 272 safeguards.

Conversely, enforcing the restriction in section 272 against BOC affiliates obtaining network elements from the BOC would not significantly interfere with the affiliate's ability to compete, because the affiliate also cannot own any network elements that it could combine with BOC network elements to provide local exchange or exchange access services. Since the affiliate cannot have its own local service network elements with which to combine network elements that it purchases from the BOC, and since the latter are typically useless without the former, the prohibition against purchasing BOC network elements is not a significant additional restriction on the affiliate, from a practical standpoint.

3. What opportunities for discrimination would exist if BOC employees maintained the interLATA facilities of the interLATA affiliate as well as the local facilities of the BOC?

Unaffiliated interexchange carriers (IXCs) must work cooperatively with BOCs when maintenance problems arise. If the same BOC employees maintain the networks of both the BOC and its interLATA affiliate, the BOC interLATA affiliate will necessarily get better cooperation than unaffiliated interLATA companies.

A simple example illustrates this unavoidable problem. If a

customer cannot complete interLATA calls, its interLATA carrier and BOC must work together to determine whether the problem is in the local network that provides access to the interLATA network, or in the interLATA network. The local and interLATA companies must work cooperatively to test circuits to pinpoint the location of the problem so that the company that maintains that part of the network can fix it. If the same BOC maintenance workers are responsible for both the BOC's local network and its interLATA affiliate's interLATA network, complete cooperation will, by definition, exist. Conversely, it would be contrary to human nature and to the economic interest of the shareholders of the BOC and its interLATA affiliate for the BOC employees who maintain the RBOC's local and interLATA networks to respond as promptly and cooperatively when the customer with the problem uses a competing interLATA service.

Cross-subsidization would also be a serious issue, since BOC employees would have to divide the time spent in identifying and solving such problems between the BOC and the interLATA affiliate. Recent Commission audits have revealed significant cost allocation issues arising from BOC employee time reporting problems, including a lack of contemporaneous time records or other underlying documentation substantiating the accuracy of employee time charges to regulated and nonregulated activities.[6]

The problem of discrimination in the type and quality of

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[6] See, e.g., Order to Show Cause, Southwestern Bell Telephone Company, AAD 95-32, FCC 95-31 (released March 3, 1995), at ¶¶ 7-12.

cooperation provided to unaffiliated interLATA carriers compared to that provided to the BOC's own affiliate also cannot be eliminated as a practical matter by nominal reporting requirements. First, there is no practical way to audit any such reports to determine that they are complete and accurate. Second, even if the reports show that problems get resolved faster for customers that used BOC interLATA services as well as local services, it would be extremely difficult and costly to determine the reasons. The BOC would doubtless claim that the problem was in the lack of experience, training, or skill on the part of the maintenance organizations of interLATA competitors, or that the better service obtained by the BOC interLATA affiliate is simply a demonstration of the economies of scope in providing local and interLATA services jointly -- for example, by minimizing transaction costs between two separate organizations. At a minimum, lengthy and costly proceedings would be necessary to determine the cause of the discrepancy. Third, it does not appear that effective relief would be available for violations. Even if damages could be proven for past violations (long after the fact), it does not seem feasible to devise effective prospective relief.

4. Why couldn't accounting safeguards take care of any problem with use of official services networks? For example, if the price at which an interLATA affiliate buys capacity were set properly, what would the problem be?

The requirement of Section 272(b)(1) that the separate interLATA affiliate "operate independently" from the BOC should be construed, as explained in MCI's comments, to mandate maximum physical separation between the BOC and its interLATA affiliate, in order to help prevent discrimination and cross-subsidization. Thus, the BOC should not jointly own or use any facilities or property with its interLATA affiliate.

As MCI and other parties also explained, the physical separation that is necessary between a BOC and its interLATA affiliate applies especially to the BOCs' "official services" networks. Although they are interLATA networks, they were ostensibly built for internal purposes, to facilitate the BOCs' provision of local, access and other intraLATA services.[7] Thus, there should not be significant extra capacity in those networks that could be used for interLATA services. If, in fact, extra capacity has been built into those networks for interLATA service purposes, the BOCs have been engaging in massive cross-subsidization. Obviously, if the BOCs are permitted to use their "official services" networks for in-region interLATA services, as well as the intraLATA services they are used for now, it will be impossible to separate BOC facilities by function or to prevent cross-subsidization or discrimination. That is why Congress already made the policy decision to require complete physical separation of the interLATA affiliate from the BOC, thus

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[7] See United States v. Western Elec. Co., 907 F.2d 160, 163-64 (D.C. Cir. 1990); United States v. Western Elec. Co., 569 F. Supp. 1057, 1097-1101 (D.D.C. 1983).

obviating any need for the complex, subjective judgments that must be made in allocating such joint facilities costs.

5. If an individual calls a BOC sales representative and asks for information about either local service or interLATA companies, can the BOC sales representative pitch the interLATA affiliate's services without mentioning that other IXCs provide interLATA service on an equal access basis? Would that violate current equal access rules? If not, how could the rules be changed without denying the BOC its right under the statute to jointly market its services and those of its interLATA affiliate?

Section 272(g)(2) permits a BOC to market or sell in-region interLATA services provided by an affiliate once the BOC satisfies the requirements of section 271. This provision allows a BOC to make out-bound telemarketing calls and to advertise through mailings or other media (e.g., newspapers, television, radio) its affiliate's interLATA services -- provided that the BOC complies with the other requirements of section 272. (For example, the affiliate must pay full and fair compensation for the marketing services provided by the BOC, and unaffiliated interLATA carriers must have the same information that the BOC uses to contact individual customers).

It would, however, eviscerate established equal access rules, and permit wholesale leveraging of monopoly power, to permit the BOC to take advantage of calls to its customer service

representatives to market its affiliate's interLATA services. BOCs receive enormous numbers of calls solely because of their current monopoly position -- for example, when families move to a new town and need local telephone service, or when a customer has a service or billing problem and calls to get it fixed. A BOC should not be permitted to take advantage of these captive customers to pitch the interLATA services of its affiliate. This would give the BOC and its interLATA affiliate a unique and immensely valuable marketing opportunity denied to its competitors.

Current equal access rules require BOCs to provide a neutral, complete description of the interLATA options available to their local service customers. If a current or prospective customer contacts a BOC with respect to local service and also asks about interLATA service choices, the BOC must identify the full range of choices on a non-discriminatory basis and refer the customer to those interLATA companies themselves for further information. Section 251(g) expressly continues these rules unless and until they are explicitly superseded by the Commission. Nothing in Section 272(g) requires any change in these rules. As explained above, compelling reasons require their continuation.

6. What are the justifications for MCI's narrow construction of the joint marketing restriction in Section 271(e)(1) on the largest IXCs? Why should joint marketing marketing for purposes

of Section 271(e)(1) be interpreted differently from joint marketing for purposes of Section 272(g)?

The focus of this rulemaking is on the interpretation and implementation of Section 272 by the BOCs, not on the right of other carriers, including all interexcange carriers, to resell BOC local services. The joint marketing provisions of Sections 272(e)(1) and 272(g)(2) serve different purposes, as will be explained. The Commission need not decide in the context of this rulemaking the parameters of Section 272(e)(1), and that provision may be most usefully addressed if and when any BOC challenges the marketing practices of a carrier that resells its services. Nevertheless, MCI will address the question posed by the staff.

In interpreting the joint marketing restrictions of Sections 271(e)(1) and 272(g)(2) applicable to the large IXCs and BOCs prior to BOC in-region authority in a given state, the Commission needs to consider the nature of the interLATA market and the focus and purposes of Section 272 and the other provisions of the 1996 Act. An academic interpretation of Sections 271(e)(1) and 272(g)(2) in isolation from the overall context in which those provisions are to be applied will undermine, rather than facilitate, the vibrant competition that now characterizes the interLATA market as well as the development of local service competition. As the Commission has repeatedly found in recent

years, the interLATA market is "substantially competitive" (1990)[8] and characterized by "aggressive price competition" (1995),[9] and "[c]ompetition for long-distance customers has become increasingly intense" (1996).[10] Last year, AT&T was found to be non-dominant under the Commission's Competitive Carrier criteria,[11] which means that no interLATA carrier has market power.[12]

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[8] Competition in the Interstate Interexchange Marketplace, CC Docket No. 90-132, Report and Order, 6 FCC Rcd 5880, 5887 (1991); Order 6 FCC Rcd 7255; Memorandum Opinion and Order, 6 FCC Rcd 7569 (1991); Memorandum Opinion and Order, 7 FCC Rcd 2677 (1992); Memorandum Opinion and Order on Reconsideration, 8 FCC Rcd 2659 (1993); Second Report and Order, 8 FCC Rcd 3668 (1993); Memorandum Opinion and Order, 8 FCC Rcd 5046 (1993); Memorandum Opinion and Order on Reconsideration, 10 FCC Rcd 4562 (1995).

[9] Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, FCC 95-427 (released Oct. 23, 1995)(AT&T Non-Dominance Order), at ¶ 64.

[10] Federal Communications Commission, Common Carrier Bureau, "Common Carrier Competition, Spring 1996," Report No. CC 96-9 (April 10, 1996).

[11] Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Therefor, CC Docket No. 79-252, Notice of Inquiry and Proposed Rulemaking (Notice), 77 FCC 2d 308 (1979); First Report and Order (First Report), 85 FCC 2d 1 (1980); Further Notice of Proposed Rulemaking, 84 FCC 2d 445 (1981); Second Further Notice of Proposed Rulemaking, 47 Fed. Reg. 17308 (1982); Second Report and Order (Second Report), 91 FCC 2d 59 (1982), recon. denied, 93 FCC 2d 54 (1983); Third Report and Order (Third Report), 48 Fed. Reg. 46791 (1983); Fourth Report and Order (Fourth Report), 95 FCC 2d 554 (1983), vacated, AT&T v. FCC, 978 F.2d 727 (D.C. Cir. 1992), cert. denied, MCI Telecommunications Corp. v. AT&T, 113 S. Ct. 3020 (1993); Fourth Further Notice of Proposed Rulemaking, 96 FCC 2d 1191 (1984); Fifth Report and Order (Fifth Report), 98 FCC 2d 1191 (1984); Sixth Report and Order (Sixth Report), 99 FCC 2d 1020 (1985), vacated sub nom., MCI Telecommunications Corp. v FCC, 765 F.2d 1186 (D.C. Cir. 1985).

[12] AT&T Non-Dominance Order at ¶¶ 138-42.

By contrast, the Commission recently reconfirmed, months after enactment of the 1996 Act, that BOCs still have "market power in ... the local exchange and exchange access market[s],"[13] which are "noncompetitive,"[14] giving the BOCs "bottleneck control over inputs into the interexchange market."[15] The 1996 Act recognizes the BOCs' continuing local market dominance in a myriad of ways, including the stringent conditions that must be satisfied before a BOC can secure authorization to provide in-region interLATA service and the separation requirements imposed by Section 272 on BOC interLATA affiliates. In effect, the separation and other requirements imposed on the BOCs, but not on IXCs, constitute a legislative recognition that the marketplace already restricts the IXCs', but not the BOCs', pricing and other behaviors. The BOCs' unconstrained local market power requires a greater degree of legislative and regulatory restrictions on joint marketing and other activities to create a level playing field between BOCs and the large IXCs.

In this context, it is inconceivable that Congress intended in Sections 271(e)(1) and 272(g)(2) to ignore the vast differences between the BOCs' local service dominance and the vigorously competitive interLATA market that it recognized in Section 272 generally and throughout the 1996 Act. The focus of

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[13] Bell Operating Company Provision of Out-of-Region Interstate, Interexchange Services, CC Docket No. 96-21, FCC 96-288 (released July 1, 1996) at ¶ 17.

[14] Id. at ¶ 39.

[15] Id. at ¶ 34.

Section 272 (as well as this docket) is the separation requirements and other safeguards necessary to ensure that the BOCs do not abuse their market power. The focus of Section 271(e)(1) -- which is unrelated to the issues of BOC safeguards -- is to prevent, for a limited time, one category of interLATA carriers from certain marketing practices relating to BOC local services that they have always had a right to resell on an unseparated basis. The two provisions thus serve very different purposes and should not be interpreted as interchangeable or parallel provisions.

It follows that those two provisions were not intended to restrict the BOCs and large IXCs in exactly the same way. In fact, the different purposes of Sections 271(e)(1) and 272(g)(2) are reflected in the relevant statutory language. Section 271(e)(1) states that the large IXCs may not "jointly market" certain local services with their interLATA services in a given state until a BOC has in-region authority in that state, while Section 272(g)(2) states more broadly that a BOC "may not market or sell [in-region] interLATA service provided by an affiliate" until it gets in-region authority. "Jointly market" in 271(e)(1) must have been intended to mean something different from the broader "market or sell" in 272(g)(2). Since Sections 271(a) and 272(a) already prohibit a BOC from providing in-region interLATA services prior to in-region authority, Section 272(g)(2) would be superfluous if it merely repeated that prohibition. Moreover, Congress could have used "jointly market" in both 271(e)(1) and

272(g)(2).

MCI submits that this difference in statutory language, in light of the different purposes of the two provisions, was intended to convey different degrees of restrictiveness, especially given the separation requirements on the BOCs, the specific purposes those requirements are intended to serve and the other competitive factors and statutory goals discussed above. For example, one aspect of the BOCs' local exchange dominance is that the BOCs have inherited a relationship with virtually every customer in their respective service regions that goes back longer than almost any telephone subscriber in America has been alive. The BOCs, moreover, enjoy name recognition at least equal to the IXCs, thanks to advertising paid for by captive ratepayers, including IXCs. If the BOCs were to exploit that monopoly hold on their local service customers in marketing their affiliates' interLATA services before satisfying the conditions for in-region authority, the competition that has developed in interLATA services would be severely harmed. That is why they may not "market or sell" their affilates' interLATA services until they gain in-region authority.

IXCs, on the other hand, have no such hold on their customers and thus are permitted to provide both local and interLATA services now and are not subject to any separation requirements. It follows that the prohibition on IXC joint marketing in Section 271(e)(1) cannot be interpreted to require, for example, that an IXC provide resold local service and its own

interLATA service out of separate entities, since that would impose a separate affiliate requirement on a carrier that has no market power in either service, something that the 1996 Act does not do. Similarly, since IXCs are not subject to any separation requirements, they may use the same sales channels and the same personnel to market local and interLATA services.

The issue thus becomes whether an IXC telemarketer, to take a specific illustration, may mention both local and interLATA services in the same call or whether he or she must hang up after discussing one service and call back to discuss the other. MCI submits that, in light of the IXCs' lack of power in either market and the absence of any separation requirements on IXC activities, it would be irrational and arbitrary to force the IXC telemarketer in this hypothetical to make two different calls and never mention the two types of service in the same call. Such an artificial constraint would effectively impose a de facto separation requirement on the large IXCs, which is not authorized by the 1996 Act or any Commission regulation. The marketplace will constrain the large IXCs enough. Such an unnecessary, artificial, extra-legal regulatory separation constraint on IXC marketing would thwart the development of local service competition that the 1996 Act was intended to promote.

For example, MCI will start off its local service marketing efforts with almost a zero market share and less than a 20 percent interLATA market share, and that interLATA share is constantly in contention. If it cannot mention both types of

service in the same marketing call or in the same advertisement, especially with regard to the over 80 percent of the market that it does not serve at all, it will never be in a position to compete with the BOCs.

The Commission should interpret the statutorily undefined phrase "joint marketing" in Section 271(e)(1) in light of the different market positions of the large IXCs and the BOCs and the purposes of the 1996 Act. That provision should therefore be interpreted to allow an IXC telemarketer or advertisement to refer to both types of services but to prohibit an IXC, as explained in MCI's comments, from offering both for a bundled price. That is the only meaning in the context of the 1996 Act as a whole that can reasonably be given to the requirement that the large IXCs not "jointly market" resold local and interLATA services. Any greater degree of restrictiveness will sabotage the main goal of the 1996 Act, which is to facilitate the development of local competition, and it would also facilitate the clear purpose of the Act to permit MCI and the other two IXCs covered by Section 271(e)(1) to resell BOC local services and to do so efficiently on an unseparated basis.

After a BOC obtains in-region authority, of course, IXCs may jointly market interLATA services and resold BOC local services, and Section 272(g)(3) permits the "joint marketing and sale" of interLATA and local services by the BOC. At that point, there will still be significant restrictions on the BOCs' activities, stemming from the separation restrictions. Thus, a BOC still

should not be allowed to bundle local and interLATA services in a single price that effectively forces the customer to buy both, and the joint marketing activity must be performed either by the BOC or its affiliate under written contract on a fully compensated basis, not together.